



Small Cap Value Emerging from the Desert: The Case for the Next Decade

2022 set records for all the wrong reasons, and small cap stocks weren't spared as the Russell 2000 posted its third worst calendar year on record. Investors wrestled with the secular shifts underway in financial markets, economic trends, geopolitical unrest, and global monetary policy—a list which remains daunting to reconcile in 2023.

What is becoming more evident is that for the first time in over a decade, small cap companies, particularly those levered to capital cycles, appear positioned for a secular bull market.

Making the case for “Why Small Caps?” would also mark a stark change from the past decade’s winners of mega-cap technology and growth companies, which benefitted greatly from free money in the zero-interest rate policy (“ZIRP”) world and limited inflation. Instead, central bank policies and economic trends are driving onshoring at the expense of globalization, tightening labor markets and pushing inflation higher at the same time. Combined with shifting investment dollars closer to home, small caps—and particularly small cap value—appear well positioned to be prime beneficiaries of capital cycles as they unfold in the coming years. The last decade has “coiled the spring” for real world businesses, and the performance of their shares, as demand rises and supply remains challenged from years of underinvestment.

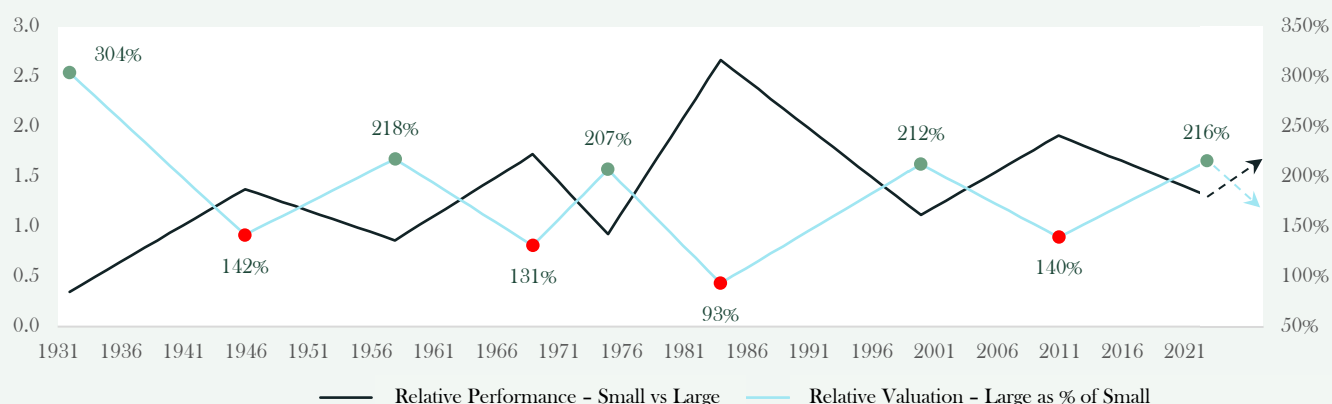
WHY SMALL CAPS

The simplest answer is valuation. Valuations for small caps are cheap—really cheap. In fact, small caps are as cheap as they have been since the dot com bubble of 2000. Looking back over the last 75 years of small caps versus large caps, bull markets have historically begun at these levels and lasted a decade on average. This intuitively makes sense for investors, considering that paradigm shifts of this nature take time—years—to come to fruition. 2023 may see the one of the most widely forecasted recessions unfold—or not, given the broad consensus call for a shallow slowdown. Given that valuations are already priced for recession, this further builds the case that small caps would likely lead sharply off the lows. (Figure 1)

Figure 1

PEAK LARGE CAP RELATIVE VALUATIONS HAVE HISTORICALLY PRECEDED THE BEGINNING OF SMALL CAP OUTPERFORMANCE

Relative Performance and Valuation Cycles: Small Caps vs Large Caps



Source: FactSet; Furey Research.

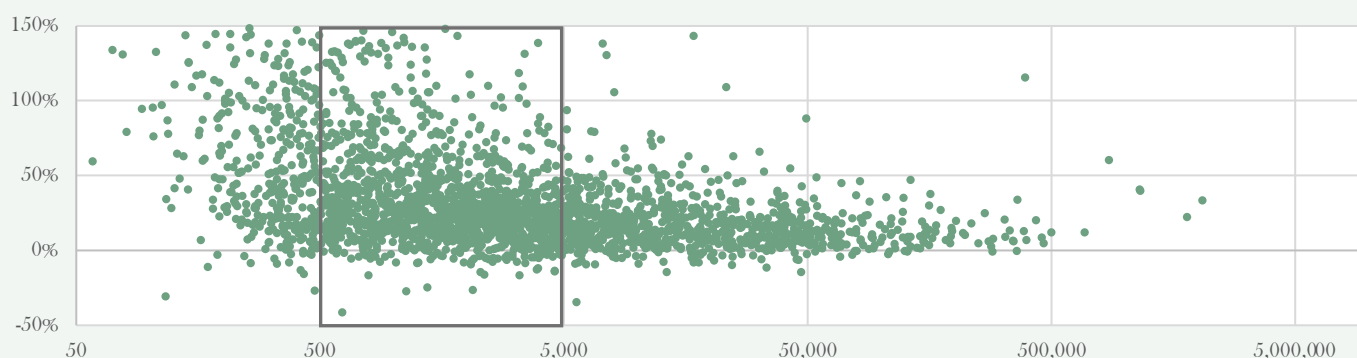
Drilling down into the underlying companies, the opportunity set for small caps remains far more attractive than that of larger companies. Looking at the Russell 3000 Index, a broad composition of stocks including both small caps and large caps, companies under \$5 billion in market capitalization have far greater expected upside based on market consensus price targets. (Figure 2)

Historically, active management has had a good track record of producing outperformance in small caps as a result of the far wider dispersion in potential outcomes. The probability that a \$1 billion company can double in value is far greater than that of a \$10 billion company, for example. With a greater potential return for each individual security, stock selection in the small cap space can produce significant, outsized returns—and has—over the long term in both absolute and relative terms.

Figure 2

MOST ATTRACTIVE UPSIDE IN \$500 MILLION TO \$5 BILLION MARKET CAPITALIZATION ACCORDING TO WALL STREET

Consensus Wall Street Price Targets vs Market Capitalization as of 12/31/22



Source: FactSet; Russell 3000 Index Universe with outliers greater than 150% excluded

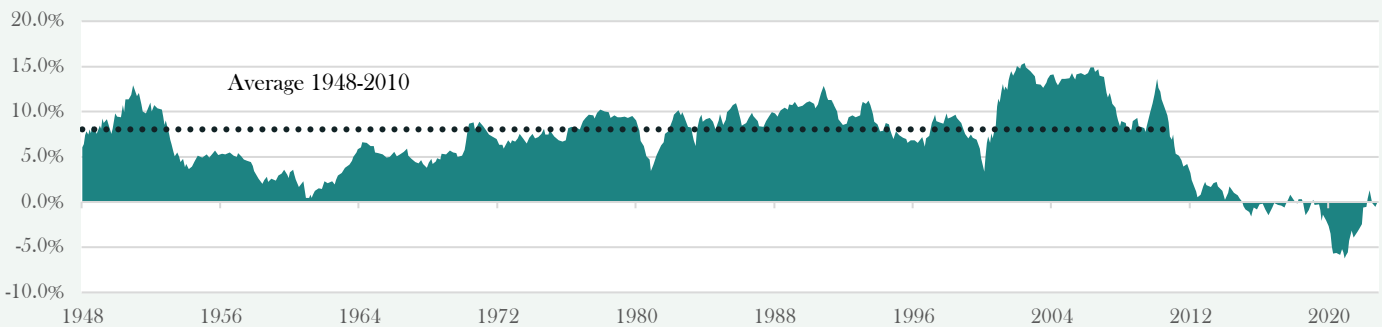
WHY SMALL CAP VALUE

Within the small cap universe, small cap value has had a challenging decade, with headwinds from an extended period of low growth, interest rates, and inflation just beginning to reverse. These headwinds weighed heavily on small cap value returns and benefitted small cap growth to a degree unseen over the last 75 years. Looking back, the annual outperformance of value over growth averaged roughly 8% over the last 65 years, but in 2015 and accelerating into the 2020 COVID pandemic, small cap growth outperformed small cap value for the first time. (Figure 3) Even with the recent reversal, economic drivers have yet to fully normalize and there remains significant upside reversion potential for many cyclical companies who invested through these challenging periods as industry consolidation drastically reduced their competitors.

Figure 3

75 YEAR HISTORY FAVORS SMALL CAP VALUE AS MARKETS NORMALIZE

Relative 10-Year Annualized Returns: Small Value vs Small Growth (1947 - 2022)



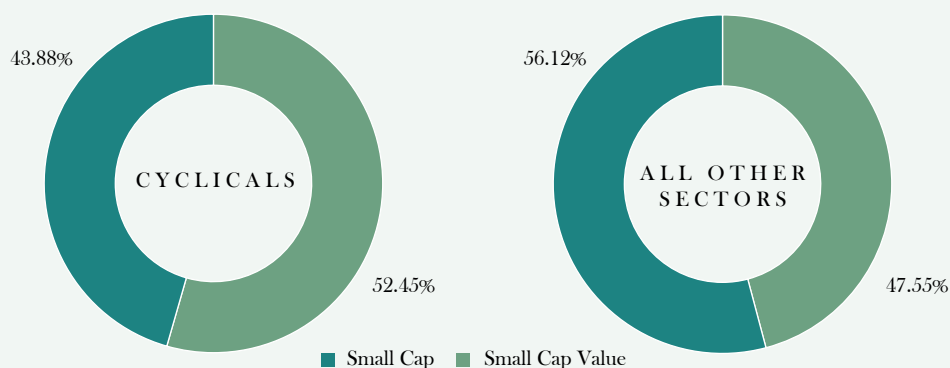
Source: Kenneth French Data Library¹

One explanation for the divergent performance lies in sector weights within small cap value and small cap growth. Small cap value has a greater weight in cyclicals while small cap growth has a greater weight in growth stocks, as one would expect. (Figure 4) While a headwind most recently, rising interest rates have resulted in a greater emphasis on prudent capital allocation and return on investment. The productivity-enhancing spending of the last decade was meaningful in terms of building intellectual property, and far less focused on capital investment. As onshoring unfolds, it will require that spending be reallocated towards fixed assets like property, plants, and equipment. Beneficiaries will be in real asset sectors—cyclicals—as companies reorganize their supply chains given the shifting backdrop. This “rising tide” of spending on hard assets will benefit small cap value far more than the broad universe, given the higher weighting in cyclicals typical for small cap value. Individual companies in areas that have been out of favor for some time and have seen firms exit the industry may stand to benefit even more.

Figure 4

GREATEST CYCLICAL EXPOSURE FOUND IN SMALL VALUE

Sector Weights: Small Value vs Broad Small Cap as of 12/31/22

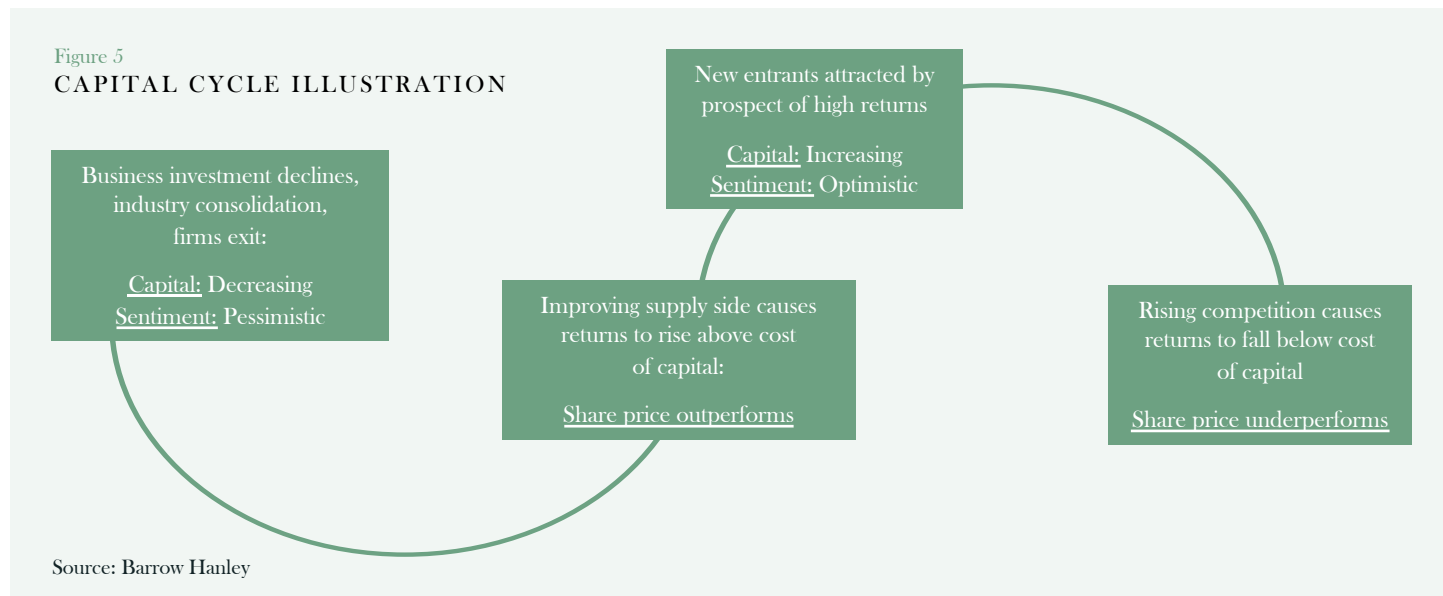


Source: FactSet, Russell. Small Value references Russell 2000 Value Index. Broad Small Cap references Russell 2000 Index. Cyclicals defined as the Financials, Materials, Industrials, and Energy sectors.

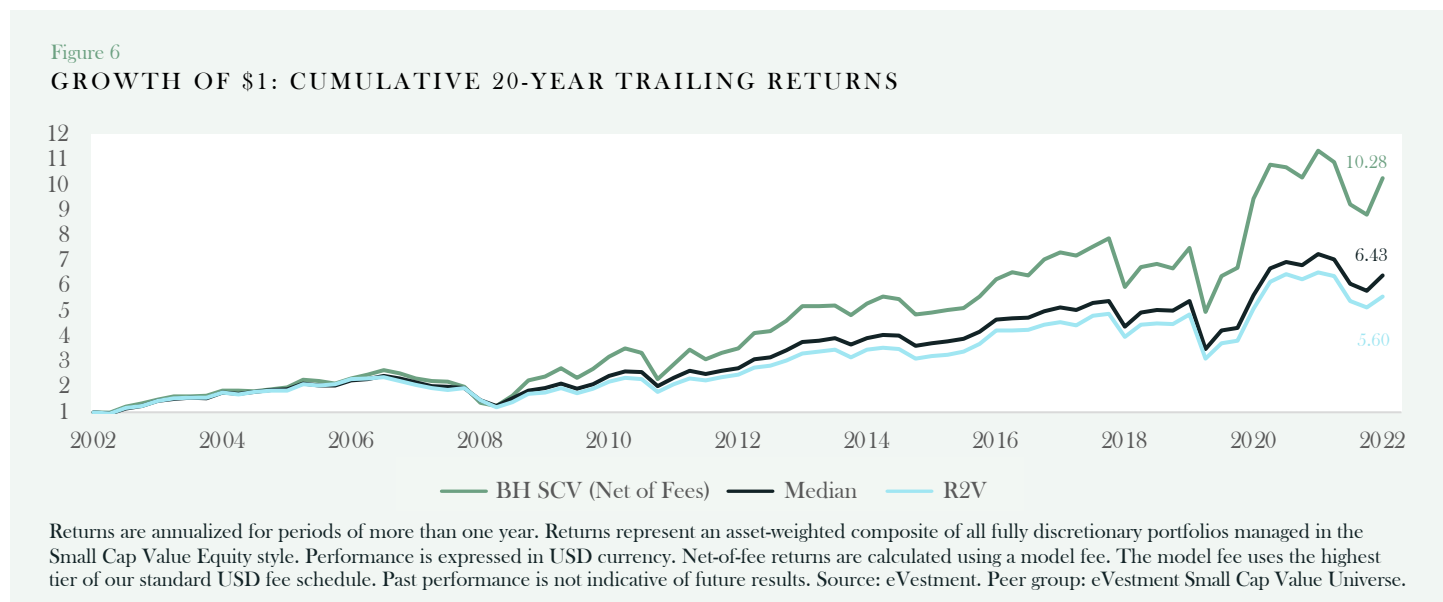
¹mba.tuck.dartmouth.edu/pages/faculty/ken.french/data_library

WHY BARROW HANLEY SMALL CAP VALUE - WHAT ARE CAPITAL CYCLES?

Over the years, the Barrow Hanley Small Cap Value team has identified a number of securities with significant value gaps benefitting from capital cycles. An illustration of the capital cycle is shown below. (Figure 5) The most important part of the curve is the trough, where investment in the industry has declined and competition is reduced via consolidation and firm exits. At this point, any potential improvement in the industry or company's outlook, say from onshoring, could lead to potential outsized profits. Often, additional supply can take quite some time to emerge as firms look for confirmation before making new investments—particularly in areas out of favor where returns on capital have declined. In the interim, incremental demand outpaces additional supply, bringing positive pricing power to help offset costs and leading to expanding margins. This creates a path higher for earnings towards a normalized earnings power, and generally, rising earnings equates to rising share prices. While not the exclusive focus of the Barrow Hanley team or portfolio, these types of companies remain an important source of potential ideas with significant value gaps that can be identified and captured via the “boots on the ground” research process.



One final and important point to make is that capital cycles tend to unfold over long periods of time, i.e., years. This aligns well with Barrow Hanley's fundamental investment approach, taking a long-term view to the potential earnings power and opportunity for each stock. Significant value gaps often arise as research coverage declines, investor interest is limited, and expectations decline. Many real-world businesses—the opposite of the darlings of the last decade—have experienced all of the above. With de-globalization just beginning, there will likely be pricing inefficiencies in small cap value equities that can be identified and captured in our concentrated portfolio of undervalued and underearning companies. With a consistent approach and experienced team, we believe the Barrow Hanley Small Cap Value strategy has demonstrated resilience despite the challenges of the last decade, outpacing peers and benchmarks (Figure 6), and may be even better positioned for the environment unfolding.



ABOUT BARROW HANLEY GLOBAL INVESTORS

Founded in 1979, Barrow Hanley is a diversified investment management firm offering value-focused investment strategies spanning global equities and fixed income. Recognized as one of the few remaining firms dedicated exclusively to value investing, Barrow Hanley enjoys a boutique culture with a singular focus to assist clients in meeting their investment objectives. Barrow Hanley stewards the capital of corporate, public, multi-employer pension plans, mutual funds, endowments and foundations, and sovereign wealth funds across North America, Europe, Asia, Australia and Africa. For further information, please visit www.barrowhanley.com.

Visit us at www.barrowhanley.com to learn more about our team, investment process, and the Barrow Hanley Small Cap Value strategy.

IMPORTANT INFORMATION

Past performance is not indicative of future results. All opinions included in this presentation constitute Barrow Hanley Global Investors' ("Barrow Hanley") judgement as of the time of issuance of this presentation and are subject to change without notice. This article was prepared by Barrow Hanley with information it believes to be reliable and is for informational purposes only and is not intended to be an offer, solicitation, or recommendation with respect to the purchase or sale of any security, nor a recommendation of services supplied by a money management organization. Barrow Hanley is a value-oriented investment manager, providing services to institutional clients. This article includes certain "forward-looking statements" including, but not limited to, Barrow Hanley's plans, projections, objectives, expectations, and intentions and other statements contained herein that are not historical facts as well as statements identified by word such as "expects," "anticipates," "intends," "plans," "believes," "seeks," "estimates," "projects," or words of similar meaning. Such statements and opinions contained herein are based on Barrow Hanley's current beliefs or expectations and are subject to significant uncertainties and changes in circumstances, many beyond Barrow Hanley's control. Actual results may differ materially from these expectations due to changes in global, political, economic, business, competitive, market, and regulatory factors.

The Russell 1000 Index measures the performance of the highest-ranking 1,000 stocks in the Russell 3000 Index. The Russell 2000 Index measures the performance of the 2,000 smaller companies included in the Russell 3000 Index. The Russell 3000 Index is a market-capitalization-weighted equity index that measures 3,000 of the largest U.S.-traded stocks. It is not possible to directly invest in an unmanaged index.

Frank Russell Company is the source and owner of the trademarks, service marks, and copyrights related to the Russell Indexes. Russell® is a trademark of Frank Russell Company. The presentation may contain confidential information and unauthorized use, disclosure, copying, dissemination or redistribution is strictly prohibited. This is a presentation of Barrow Hanley. Russell Investment Group is not responsible for the formatting or configuration of this material or for any inaccuracy in Barrow Hanley's presentation thereof.

Please contact us for
more information.

214.665.1900
contactus@barrowhanley.com
www.barrowhanley.com

Barrow Hanley Global Investors
2200 Ross Avenue, 31st Floor
Dallas, TX 75201